

Strategic Plan FY2008 and Beyond

Endowment Fund Investment Board Of the State of Idaho



August 9, 2007

Mission of the Endowment Fund Investment Board

Provide professional investment management services to our stakeholders consistent with our constitutional and statutory mandates.

Goals

We will provide good investment advice and the tools for implementing that advice. As our clients' individual needs require, we will:

- Develop a prudent long-term investment strategy
- Select the best portfolio managers and other agents to execute that strategy
- Diligently evaluate performance over time
- Develop an effective spending policy
- Help them fulfill their fiduciary responsibilities and communicate with their stakeholders

For our employees, we will:

- Create a work environment which motivates and retains a knowledgeable and professional staff

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Objectives

Some of the objectives of the Endowment Fund Investment Board are similar for all our clients – the endowment funds, the State Insurance Fund and the Judges' Retirement Fund, while others only apply to a specific client or our employees.

Objectives Applicable to All Clients

- Seek new approaches to improve portfolio risk/return characteristics and cost/benefit ratios
- Meet or exceed the client's fund benchmark(s)

Objectives Specific to the Endowment Funds

- Review asset allocation and spending policy by May, 2008
- Recommend a new (or reconfirm the current) Spending Policy to the Land Board by August, 2008
- Avoid reductions in total endowment distributions
- Long-term, increase distributions to 4% of the value of the endowment funds plus the net cash earnings of the endowment lands while at the same time, growing Earnings Reserves to protect distributions from temporary shortfalls in revenues
- Refine the process for granting school bond guarantees and clarify the interest rate required in statute – confer with appropriate stakeholders and prepare legislation for introduction in January 2009

Objectives for our employees:

- Build relationships with other key agencies
- Train/cross-train the Administrative Assistant, the Investment Officer, and the Senior Financial Specialist in key financial and investment due diligence tasks

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Key performance measures and benchmarks

(including the rationale for their adoption)

The efficacy of the Endowment Fund Investment Board's management can best be measured by:

- *The risk-adjusted performance of the portfolios of each of our clients*
- *The length of time that the Public School Permanent Fund is below its loss benchmark*
- *The quality of our recommendations to the Land Board regarding the level of distributions*

Risk/Return Measures & Benchmarks

These measures will be calculated annually and over multi-year periods

- *Measure: Absolute return*
 - *Endowment funds: 4% annually after inflation*
 - *Judges' Retirement Fund: 7.75% annually net of fees*
- *Measure: Return vs. benchmark*
 - *Endowment Funds: exceed Fund benchmark on a risk-adjusted basis*
 - *Judges' Retirement Fund: exceed Fund benchmark by at least 0.5% annually with the same risk as the benchmark*
 - *State Insurance Fund: meet or exceed the Fund's benchmark*
- *Measure: Return vs. peers*
 - *Endowment funds: Exceed median of peers on a risk-adjusted basis*

- *Judges' Retirement Fund*: Exceed median of peers on a risk-adjusted basis

Rationale for establishing these measures/benchmarks

There is no single, perfect measure of the performance of an investment portfolio, so multiple performance measurements will be used, customized to the needs of each client and calculated for both annual and multi-year periods.

Absolute return: *This is based on the long-term return needs of the client, relative to the level of risk/volatility they are able to endure. It can be stated in both "nominal" or "real" (after inflation) terms. It is unlikely a portfolio will achieve this return every year, but rather represents the expected return over several market cycles. Achieving the absolute return target over time is generally more critical for clients like pension plans, whose funding needs (e.g. liabilities) do not vary with markets.*

Return vs. benchmark: *This is a relative return measure that calculates the value-added of "active" versus "passive" investing. One can invest in many (but not all) major asset classes in the financial markets thru either index funds or via active management. Index funds essentially own a representative portion of the whole market and are therefore referred to as "passive" investments because they do not attempt to predict which specific securities in the class will perform best. "Active" investing attempts to select the assets within a class that will perform better than average. The efficiency of financial markets makes it challenging to earn active returns in excess of the passive index without taking extra risk.*

Return vs. peers: *Since a rising tide lifts all boats, comparison to relevant peers, adjusted for risk, allows one to measure whether a fund is doing better or worse than similar participants in the financial markets. It measures a fund's ability to make investment choices better than average, but*

is difficult to achieve over time because, by definition, half of all funds striving to be above average end up being below average. Also, certain peer group data is only available annually and one can never find a perfectly similar peer group, which limits the value of peer comparison.

Public School Endowment Fund Measures & Benchmarks

- *Measure:* Number of years below cumulative loss benchmark
 - Less than 10 years

Rationale for establishing the measure/benchmark

The state Constitution requires the state to make up any losses in the Public School Permanent Endowment Fund. Idaho Code specifies that these losses must be made up after ten consecutive years of cumulative losses, as measured at fiscal-year end. Deposits to the fund from the sale of land or extraction of minerals cannot be counted in determining whether the loss benchmark has been met and cash returns (interest and dividends) are not transferred into the permanent fund. Therefore, exceeding the loss benchmark is driven exclusively by the net capital gains of the portfolio.

Thru the end of FY2005, the Public School Permanent Fund had been below the loss benchmark for four consecutive years. However, by FY2006, good investment results put the Fund back into the cumulative gain column where it remained at the end of FY2007.

Public School Permanent Endowment Fund
Cummulative Gain(Loss) Calculation
(millions of dollars)

	<u>Loss Benchmark</u>	<u>Actual Fund Balance</u>	<u>Cummulative Gain (Loss)</u>
Beginning Balance FY2000	556.0	556.0	-
Deposits - FY01	1.7		
Balance FY2001	557.7	511.7	(46.0)
Deposits - FY02	1.4		
Balance FY2002	559.1	441.5	(117.5)
Deposits - FY03	2.2		
Balance FY2003	561.3	436.2	(125.1)
Deposits - FY04	0.8		
Balance FY2004	562.1	500.6	(61.5)
Deposits - FY05	1.6		
Balance FY2005	563.6	537.2	(26.5)
Deposits - FY06	1.8		
Balance FY2006	565.4	582.4	17.0
Deposits - FY07 E	3.4		
Balance FY2007 E	568.8	662.5	93.7

Source: EFIB records

Endowment Distribution Measures & Benchmarks

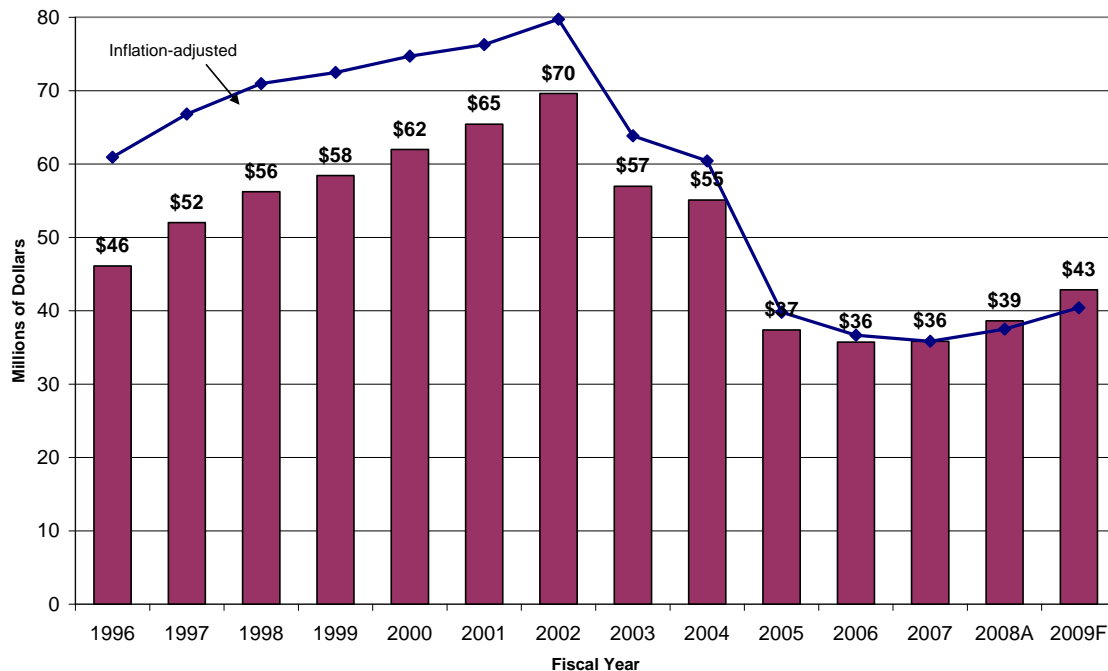
- *Measure:* Change in distributions to beneficiaries
 - No reductions in total endowment distributions
 - Within ten years, increase distributions for each beneficiary to 4% of the value of its endowment fund plus the average of the last five years' cash earnings from its endowment lands

Rationale for establishing the measure/benchmark

The adequacy of the returns of the endowment funds and the efficacy of the Spending Policy are ultimately measured in terms of the distributions to the beneficiaries, both in absolute dollars and in consistency from year-to-year. While the vision of the state's land and financial endowment assets is to grow distributions over time at a rate in excess of inflation, endowment beneficiaries experienced declining distributions for four years straight after FY2002 due to lower

timber revenues than expected, especially in FY2003 and FY2005, the significant bear market in equities in 2000-2002, and a high level of distributions in FY2001 and FY2002 relative to the size of the reserves. The drop in distributions in FY2003 was especially traumatic, because it coincided with a significant shortfall in expected General Fund revenues.

**Total Endowment Distributions To Beneficiaries
1996-2009 Actual, Approved and Forecasted, Nominal and
Inflation-Adjusted (in 2007\$)**
(Net of General Fund Contribution in 2006 of \$4.6MM)



Source: Legislative Services, EFIB records

Bringing distributions up to the long-term objective of 4% plus net land revenues will take time. Good investment returns in the last few years have offset the losses of FY2001 and FY2002 and almost made up for the impact of inflation. While the endowment funds can currently distribute interest and dividends, they can only distribute capital gains in excess of inflation. At the end of FY2007, the Public

School Fund, for example, was approximately 3% behind the amount needed to keep up with inflation (the “Gain Benchmark”).

As each endowment exceeds its inflation-adjusted target, it can then pay out distributions of total gains, including capital gains, rather than only paying out interest and dividends. However, this will increase volatility of income to the reserves (for further discussion see the end of the External Factors section).

Earnings Reserve funds for all endowments were at record levels at the end of FY2007 and are expected to grow further in FY2008, increasing the security of future distributions. The near-term challenge is to grow distributions toward their potential at a prudent pace while growing reserves to an optimal level which minimizes the possibility of any future reduction in total distributions.

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External factors

that could significantly affect the achievement of our goals and objectives

The major outside factors impacting the EFIB are the returns and volatility of the financial markets and the level of timber revenues from endowment lands.

I. Financial Markets

All of the portfolios managed by the Endowment Fund Investment Board are subject to the variability of the financial markets and to the threat of eroding purchasing power due to inflation.

The EFIB attempts to mitigate some of the market risk by investing in diversified portfolios of assets so that the expected variation in the whole portfolio is less than the sum of the variations of each part. The following table demonstrates the sensitivity of each client's portfolio to different asset classes.

Exposure To Financial Markets By Client

	<u>% Of Assets Invested</u>			<i>Five-Year</i>	<i>Annual</i>
	<u>Endowment</u>	<u>State Ins.</u>	<u>Judges'</u>	<u>Expected</u>	<u>Absolute</u>
	<u>Funds</u>	<u>Fund</u>	<u>Fund</u>	<u>Return*</u>	<u>Risk</u>
<u>Equities</u>					
Developed markets					
U.S.	56%	10%	56%	9.0%	17%
Foreign	13%	3%	13%	9.2%	20%
Emerging markets	1%	0%	1%	9.6%	30%
Private equity	0%	0%	0%	12.0%	34%
High yield debt	0%	0%	0%		
Total Equities	70%	13%	70%		
<u>Fixed Income</u>					
Treasuries/Agencies					
Standard	8%	43%	10%	4.8%	6%
Inflation-protected	3%	9%	0%	4.5%	7%
Mortgages (agency)	5%	12%	5%	5.2%	6%
Mortgages (non-agency)	10%	14%	11%	5.2%	6%
Corporates, other	4%	9%	4%	5.4%	6%
Total Fixed Income	30%	87%	30%		
Real Estate	0%	0%	0%	7.6%	16%
Absolute Return	0%	0%	0%	6.5%	10%
Total	100%	100%	100%		
Duration/Maturity of					
Fixed Income (years)	4.7	3.8	4.6		

* Assumes annual inflation rate of 2.75%

Source: Callan, EFIB analysis

II. Cash Flow From Lands

For the endowment funds, the performance of the land assets is another major external factor that can significantly affect the achievement of our objectives of increasing distributions and avoiding reductions. Viewing all endowment assets, land and financial together, the value of the land is approximately equal to the value of the funds. As a result, about half of the sensitivity of the return on total endowment assets is driven by the return on the lands and about half by the return of the funds.

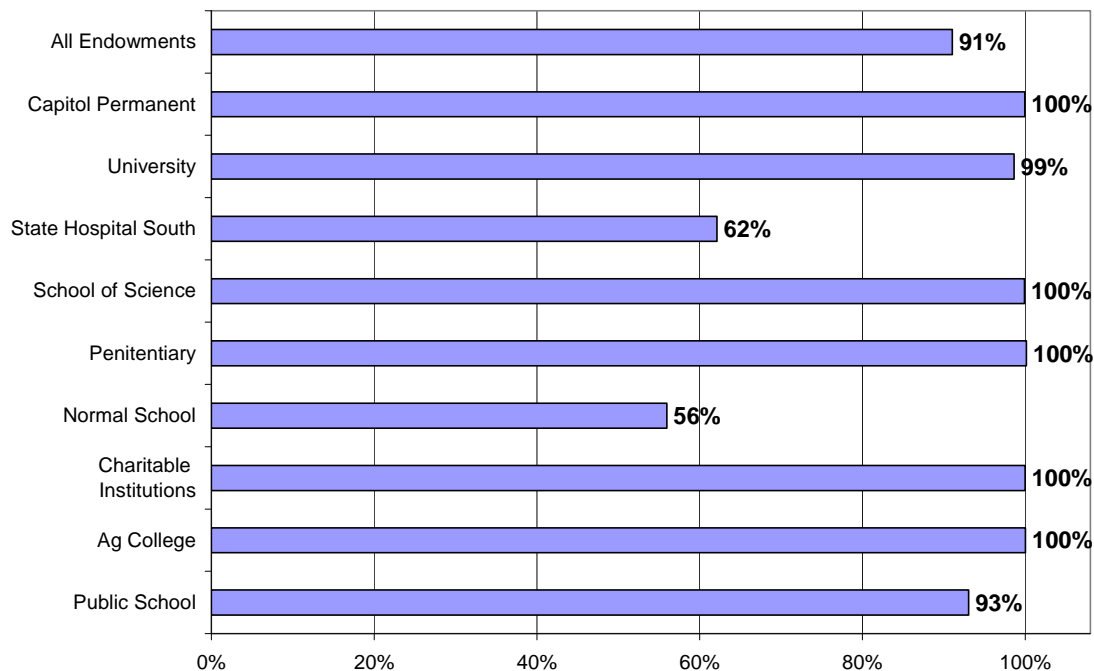
Because the land assets generate a significant portion of each endowment's total revenue, variations in the total cash available for distribution to endowment beneficiaries is highly subject to the variations in net cash earnings of the endowment lands. Over the last six fiscal years, these earnings have averaged \$45 million annually, with a range of about plus or minus \$7 million (17%).

(Millions of \$)	<u>FY01</u>	<u>FY02</u>	<u>FY03</u>	<u>FY04</u>	<u>FY05</u>	<u>FY06</u>	<u>FY07</u>	<u>Average</u>
Net Lands Revenues	49	42	35	50	38	47	52	45

Source: Legislative Services, EFIB analysis

As shown below, 50% to 100% of the net land revenues of each of the endowments come from the sale of timber, so the earnings from their land is very sensitive to the price and volume harvested of timber.

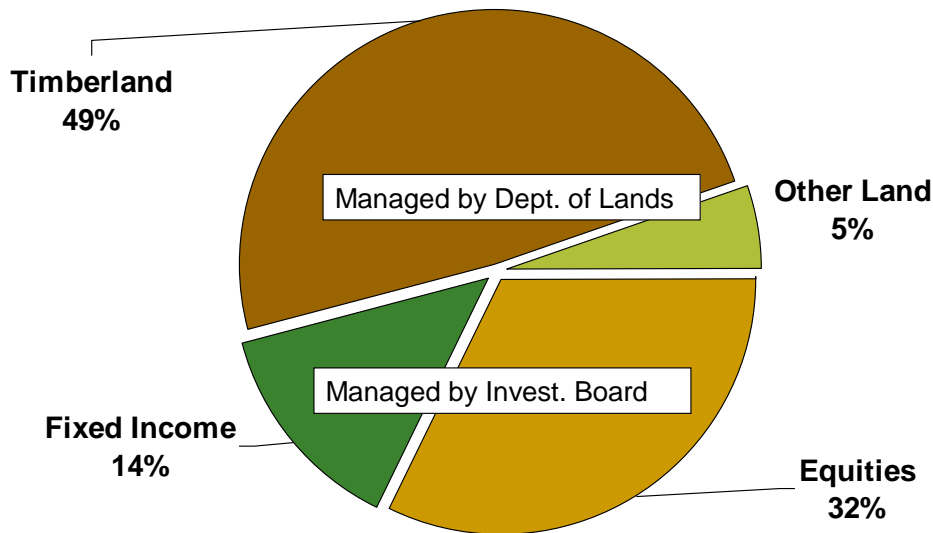
% Of Lands' Earnings Reserve Income From Timber - FY 2005 & 2006



Source: Idaho Department of Lands 2005 Annual Report, EFIB analysis

When financial and land assets are combined, the mix of total endowment assets is 49% Timberland, 32% Equities, 14% Fixed Income and 5% other Real Estate (primarily vacation property ground rents).

Mix of All Endowment Assets (Assuming Land value of \$1.1 billion)

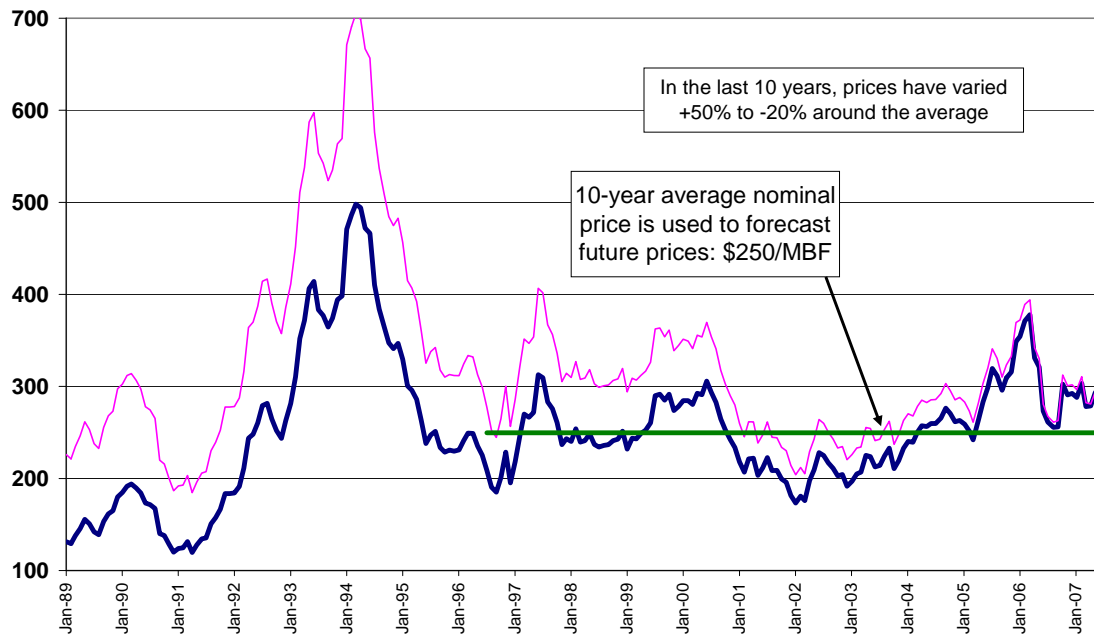


Total value of all assets = approximately \$2.2 billion

Source: EFIB estimates

Since almost half of endowment earnings come from timber, a major external factor outside the Endowment Fund Investment Board's control is the price of timber and the volume of harvest. The following graph demonstrates the variability of timber prices:

Idaho Department of Lands Log Price Trends (at Bid) Actual and Inflation Adjusted -- Six Month Rolling Ave

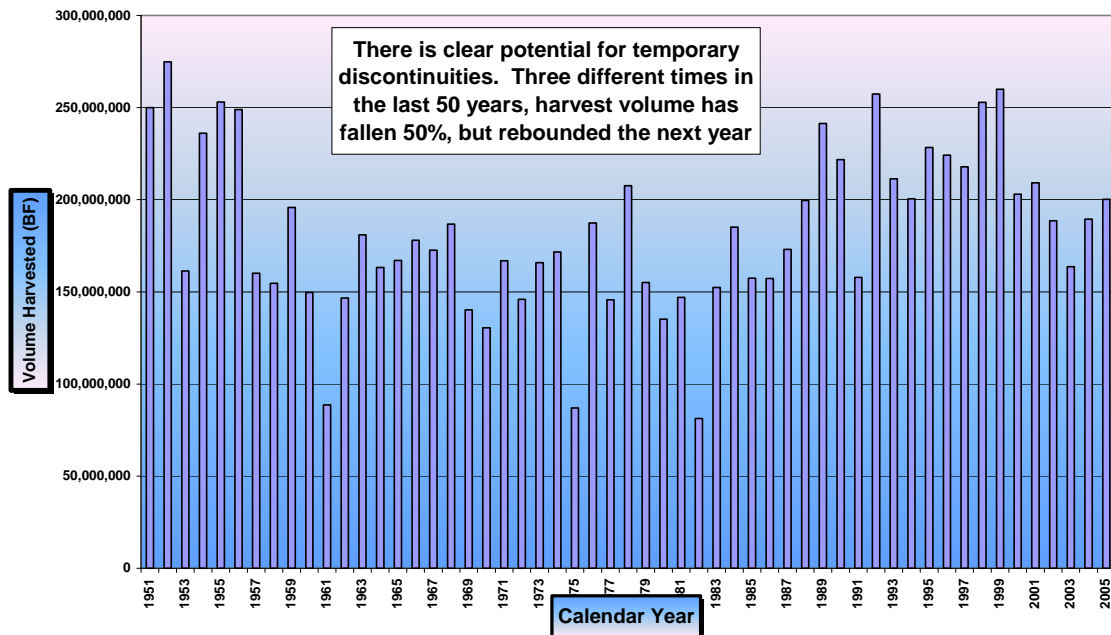


Source: Idaho Department of Lands, EFIB analysis

Like the stock market, timber prices are essentially unpredictable, so this adds significant risk of error to any cash flow forecast the EFIB might use to develop recommended distribution levels.

The volume of total harvest can also vary from year-to-year.

Sawlog Harvest Volumes By Calendar Year -- 1951 to 2005



Source: Department of Lands

Because 70% of the endowment timberlands are for the benefit of public schools, the above graph is a fair representation of the variation in harvest levels on school lands. However, since the land bases of the other eight endowments are significantly smaller (see table below), the variations in their harvest levels from year to year are even larger than the graph above implies and therefore very hard to predict.

<u>Endowment</u>	<u>Acres of Forested Land</u>			<u>% of Total</u>
	<u>Primary</u>	<u>Secondary</u>	<u>Total</u>	
Public Schools	570,087	183,039	753,126	73%
Charitable Institutions	60,245	996	61,241	6%
School of Science	58,301	2,582	60,883	6%
University of Idaho	41,845	991	42,836	4%
Normal School	40,547	2,116	42,663	4%
State Hospital South	25,753	768	26,521	3%
Penitentiary	26,023	56	26,079	3%
Agricultural College	14,406	96	14,502	1%
Capitol	6,465	336	6,801	1%
Total	843,672	190,980	1,034,652	100%

Source: Idaho Department of Lands 6/30/2006 Annual Report

The variability of land revenues for six of the small endowments over the past six years is two to five times greater than the Public School endowment, as shown below.

	<u>Average Annual Revenues (\$ million)</u>	<u>6-Year Standard Deviation (% of Ave.)</u>
Normal School	3.3	11%
Public Schools	39.7	12%
Charitable Institutions	2.8	19%
State Hospital South	3.3	21%
School of Science	3.4	42%
University of Idaho	3.2	45%
Penitentiary	1.5	64%
Agricultural College	0.6	88%
Total	56.5	10%

Source: EFIB analysis thru FY2006. Data is not available for the Capitol Permanent Fund.

To address this extreme variability, the EFIB is working with the Reform Review Task Force and the Department of Lands to consolidate the land holdings of the eight small endowments into a common ownership – i.e. rather than having 100% ownership of a few acres, each endowment would have a smaller percentage ownership of a larger number of acres. This would have numerous risk-reducing benefits and help smooth out variability in the level of timber harvests.

A future source of increased revenue variability will arise as each endowment's permanent fund passes its "gain benchmark", essentially the June 2000 level adjusted for inflation and certain deposits. When this occurs, the flow of investment income to the earnings reserve fund will change. Currently, interest and dividends are added to earnings reserves each year. However, by statute, a year after the gain benchmark is achieved, then the total gain (interest, dividends, and capital gains/losses) above inflation will flow to earnings reserves annually. While this will increase potential revenues due to the inclusion of capital gains, it will result in zero revenues flowing to reserves in years in which there are capital losses in the stock market.

This revised flow of income will help protect the inflation-adjusted corpus or principal in the permanent fund, since interest and dividends will be used to offset capital losses. However, that means interest and dividend income will no longer be available every year to help fund distributions.